VI. OFTEL Approach

As the FCC is well aware, the United Kingdom's Office of Telecommunications (OFTEL) has been in the forefront of regulatory reform for over a decade, basically since its inception at the time of the BT privatization. OFTEL is now concluding a major recasting of its "conveyance charge" regime — basically, the framework within which charges for network inputs will be established in the future.[12] OFTEL's reform effort is thus closely analogous to the many of the FCC's on-going efforts to implement provisions of the Telecommunications Act.

Conveyance charges in the U.K. have heretofore been individually set on the basis of historic embedded costs. OFTEL now proposes to establish a network service price cap under which BT will be afforded considerable flexibility to set individual prices subject to overall cap constraints and within a zone of economic reasonableness. Over the last few years OFTEL has expended considerable effort on the empirical estimation of suitable values to be utilized for initialization of its new network service price cap regime. Charges are to be set initially on the basis of forward-looking incremental costs *plus* a markup to cover an allocated portion of relevant overheads assigned via an accounting convention.[13]

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[12] OFTEL: *Effective Competition: Framework for Action, A Statement on the Future of Interconnection, Competition and Related Issues,* July 1995; *Pricing of Telecommunications Services from 1997, Consultative Document on BT Price Controls and Interconnection Charging,* December 1995; *Pricing of Telecommunications Services from 1997, Second Consultative Document on BT Price Controls and Interconnection Charging,* March 1996; and *Pricing of Telecommunications Services from 1997, OFTEL's Proposals for Price Control and Fair Trading,* June 1996.

[13] The problem of recovery of historical burdens stemming from inadequate depreciation under regulation has loomed less largely in the U.K. Similarly, BT has been afforded substantial freedom to rebalance its rates so that issues arising from the need to cope with distortions on this account have been largely mooted.

To initialize parameters for the new price-cap scheme, OFTEL's approach has been *to analyze both top-down and bottom-up costs empirical estimates* to get a handle on incremental costs. As noted, OFTEL also recognizes the need for a markup over incremental costs to permit necessary recovery of overhead costs. OFTEL's Staff initially estimated a bottom-up cost model, and BT submitted its own model of incremental costs based on a top-down approach. OFTEL has acknowledged comparative strengths and weaknesses of the two approaches, and sought to identify ways in which *each* of the approaches might be strengthened. Modifications to each model have been implemented to address OFTEL's concerns and suggestions for improvements.

Perhaps not unsurprisingly, there remain significant differences in the estimates produced by the two approaches even after making the adjustments OFTEL requested. OFTEL has expended considerable efforts to identity the reasons for remaining differences and to reconcile the two sets of estimates.[14] This process of reconciliation has involved identification of changes in each model's specification and inputs, the respective implementation and use of which have now produced estimates that are approximately equal. Generally speaking, the results of the effort to reconcile top-down and bottom-up estimates has resulted in hybrid numbers that roughly split the difference between the two.

There are several aspects of OFTEL's effort upon which it is worth remarking in the context of the FCC's modeling effort:

(1) OFTEL has acknowledged the prudence of inclusive measures of recoverable cost, recognizing the need for recovery of overheads. OFTEL has, similarly, afforded freedom for substantial rate rebalancing thus avoiding the need for a distorted system of network input charges.

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[14] OFTEL, *Reconciliation and Integration of Top Down and Bottom Up Models of Incremental Cost*, June 1996.

(2) OFTEL has undertaken a careful and thorough analysis of different costing methodologies in an effort to produce accurate and analytically meaningful cost estimates.

(3) OFTEL has expended substantial efforts to understand the reasons why cost estimates differ and to reconcile conflicting estimates. This process has resulted in sound cost estimates in which both the regulator and the industry have confidence and this has increased the (already high) credibility of the government's policy. It has also had the highly beneficial effect of rendering OFTEL's policymaking process highly transparent and lending it decisions a high degree of clarity. Interested parties have all been permitted and encouraged to participate in the process of reconciliation. Not only have the sources of differences been revealed, significant efforts have been made to reconcile differences. Where differences remain, it is clear why they remain and what specific tradeoffs the regulator is making. This, in turn, supplies a basis for inferring the regulator's revealed preferences and for comparing revealed preferences with stated policy objectives. Thus, there is policy transparency and the ability readily to assess the regulator's performance.

VII. Conclusion

Economic modeling can aid in making good regulatory decisions. To make improvements, the Commission should subject both its model and the various empirical inputs to its model to a high degree of continuing critical scrutiny. In particular, the Commission should carefully consider the attributes of both top-down and bottom-up estimates of the costs of a legacy network (as opposed to a green-field model of a hypothetical network). Where those estimates differ, it should attempt to reconcile them, much in the manner OFTEL has done. It is only through a process of critical

appraisal and contrast and comparison of alternatives that the Commission can produce policy transparency and clarity.